OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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MEMORANDUM FOR: **DISTRICT COUNSEL, PACIFIC NORTHWEST**
PORTLAND OFFICE CC:WR:PNW:POR

FROM: **DEBORAH A. BUTLER**
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT:

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

This Field Service Advice responds to your memorandum dated August 5, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

X Corp. =
Y Corp. =
Z Corp. =
m =
n =
p =
q =
r =
s =
t =
u =
v =
w =
x =

y	=
z	=
Date 1	=
Date 2	=
Date 3	=
Term A	=
Term B	=
Exercise Period	=

ISSUE:

Whether the taxpayer is entitled to an interest deduction for the amount paid to an unrelated party under a Shadow Warrant Agreement executed in conjunction with a loan transaction between the parties.

CONCLUSION:

We concur in your advice that the Shadow Warrant Agreement is integrally related to the Credit Agreement which was part of a financing transaction. [redacted]

FACTS:

On Date 2, X Corp. and Y Corp., an unrelated financial lender, entered into a credit agreement and a Shadow Warrant Agreement. The loans were fully secured, not convertible into stock and Y Corp. was given no participation in the management of the company. Under the credit agreement, Y Corp. received a closing fee of $s. Y Corp. agreed to provide financing to X Corp. as follows:

- Term Loan A, in the amount of q, payable in quarterly installments over Term A (interest at prime rate plus % or LIBOR plus %, as selected by X Corp.);
- Term Loan B, in the amount of $r, payable in quarterly installments over Term B (interest rate of % per annum); and
- $r Revolving Loan, in the amount of $r due and payable if Term Loan A and Term Loan B were paid in full (interest at prime rate plus % or LIBOR plus %, as selected by X Corp.);
- Letter of Credit Guaranty of up to $z of industrial development bonds already outstanding.

The Credit Agreement provided that as a condition of making the loan, the Shadow Warrant Agreement must be delivered to Y Corp. on or before the closing date. The Shadow Warrant Agreement stated that the initial warrants were being issued to Y Corp. "in order to induce the Initial Holder to enter into and advance funds pursuant to the Credit Agreement." The Shadow Warrant Agreement specifically states that nothing in its terms should be construed as granting the holder a right to purchase stock, to receive notice of or to vote at shareholder meetings, or to any rights as a shareholder. The shadow warrants were transferable.

Upon exercise of the warrants, Y Corp. was entitled to a Contingent Payment which was the greater of the fair market value per share or book value per share of m shadow warrant shares, minus the base price of $z per share. They could be exercised during the Exercise Period or upon the occurrence of an Exercise Event. An Exercise Event was defined as a merger, complete liquidation, sale of substantially all assets, or a sale of more than ten percent of outstanding capital stock. In addition, the Shadow Warrant Agreement contained antidilution provisions which increased the number of shadow warrant shares and/or decreased the base price in the event that X Corp. issued additional shares at less than the base price. There was also a provision for the holder of the shadow warrants to share in corporate distributions. In essence, these provisions were designed to protect Y Corp.'s right to receive the Contingent Payment, which should equal n% of the value of X Corp. A 1992 amendment to the Shadow Warrant Agreement changed the applicable percentage to p% while at the same time increasing the number of shadow warrant shares to m.

On Date 2, X Corp. was purchased by Z Corp. In accordance with the agreements, Y Corp. exercised the warrants. The Contingent Payment was computed as $t but on the date of the merger, Y Corp. received a payment of only $u. An additional $v was payed to Y Corp. during the taxable year.

On the federal income tax return for the period ending 9503, X Corp. claimed an interest expense deduction in the amount of $t. During the audit, X Corp. has agreed that the interest expense deduction is limited to the amount actually paid during the year but continues to assert that an interest expense deduction is allowable. The revenue agent has raised questions about the treatment of the warrants for tax purposes. He is considering whether the shadow warrants are more properly characterized as equity. In this regard, he has also suggested that because the Credit Agreement and the Shadow Warrant Agreement are two separate documents, they should be considered independently.

LAW AND ANALYSIS

I.R.C. § 163 allows a deduction for all interest paid or accrued within the taxable year. Interest is the amount which one has contracted to pay for the use,

forbearance or detention of money. Deputy v. du Pont, 308 U.S. 488 (1940); Old Colony R.R. Co. v. Commissioner, 284 U.S. 552 (1932); Rev. Rul. 76-413, 1976-2 C.B. 213. A payment may not be denominated as interest but a taxpayer will nonetheless be entitled to a section 163 deduction because it is in substance interest. Byerlite Corp. v. Williams, 286 F.2d 285 (6th Cir. 1960); Dorzback v. Collison, 195 F.2d 69 (3rd Cir. 1969); A.R. Jones Syndicate v. Commissioner, 23 F.2d 833 (7th Cir. 1927); deReitzes-Marienwert v. Commissioner, 21 T.C. 846 (1954).

The revenue agent proposes that the Credit Agreement and the Shadow Warrant Agreement should be considered separately rather than as integrally related and part of the same transaction. While the loan and warrant agreements are separate documents, they were executed at the same time and emanate from the same transaction. We agree with the conclusion that an analysis of the Shadow Warrant Agreement cannot be complete without taking into account the entire transaction, which includes the Credit Agreement. The execution and delivery of the Shadow Warrant Agreement is a condition of the loan. The two cannot be viewed as having independent significance unrelated to the other.

The determination of whether an instrument represents debt or equity is a question of fact. John Kelly Co. v. Commissioner, 326 U.S. 521 (1946); Berkowitz v. United States, 411 F.2d 818 (5th Cir. 1969); O.H. Kruse Grain & Milling v. Commissioner, 279 F.2d 123 (9th Cir. 1960); Litton Business Sys. Inc. v. Commissioner, 63 T.C. 367 (1973). The ultimate issue is whether there is a genuine intention to create a debt, with a reasonable expectation of repayment and did that intention comport with the economic reality of creating a debtor-creditor relationship. The intent of the parties is derived from the total effect of what occurred. O'Hare v. Commissioner, 641 F.2d 83 (2nd Cir. 1981); Comtel Corp. v. Commissioner, 376 F.2d 791 (2nd Cir. 1981). Among the factors the courts consider: the names given to the certificates evidencing the indebtedness; the presence or absence of a fixed maturity date; the source of payment; the right to enforce payments; the extent of participation in management by the holder of the instrument; status of the advances in relation to regular corporate creditors; intent of the parties; identity of interest between creditors and shareholders; the 'thinness' of capital structure in relation to the debt; the ability of the corporation to obtain funds from outside sources; the use to which advances were put; the failure of debtor to repay; and the risk involved. Wilbur Roth Steel Tube Co. v. Commissioner, 800 F.2d 625 (6th Cir. 1986); Raymond v. United States, 511 F.2d 185 (6th Cir. 1975); Austin Village, Inc. v. United States, 432 F.2d 741 (6th Cir. 1970); Montclair, Inc. v. Commissioner, 318 F.2d 38 (5th Cir. 1963); Dixie Dairies Corp. v. Commissioner, 74 T.C. 476 (1980), acq., 1982-2 C.B. 1.

No one of these factors is determinative. Wilbur Security Co. v. Commissioner, 279 F.2d 657 (9th Cir. 1959); Consumers Credit Rural Electric Cooperative Corp. v. Commissioner, 319 F.2d 475 (9th Cir. 1963). They are only

aids in answering the ultimate question of whether the investment, analyzed in terms of its economic reality, constitutes risk capital entirely subject to the fortunes of the corporate venture or represents a strict debtor-creditor relationship. Bradshaw v. United States, 683 F.2d 365 (Ct. Cl. 1982). Applying these factors to the facts of this case, we make the following observations:

1. Names given the certificates: Exam argues that the term warrant connotes an equity interest, however, warrants have sometimes been variously treated as debt and others as equity.

2. Presence of a maturity date: Term Loans A and B have maturity dates but the revolving loan is due and payable only when and **if** the term loans are fully paid. The shadow warrants are exercisable over a five year period. If not exercised by that date or upon the occurrence of an Exercise Event, the warrants would expire unpaid.

3. The source of the payment: Exam correctly points out that under the agreement, all payments of the shadow warrants are tied to equity distributions or the appreciation of the value of X Corp. stock. To the extent that X Corp. made a distribution to its shareholders, it seems clear that the pro-rata payment which Y Corp. received would be derived from the same source from which the stock distribution was made–usually earnings and profits. Payment upon the occurrence of an Exercise Event would seem to derive from net proceeds available to shareholders. (Indicates equity)

4. Right to enforce the payment of principal and interest: Upon either the occurrence of an Exercise Event or exercise by X Corp., the agreement specifies the warrantholder's remedies at law in the event of either default or violation of the agreement, including specific performance or injunction. Thus, there are provisions to enforce payment of the contingent payment. However, if the value of the stock does not exceed $x, Y Corp. is entitled to nothing. (Indicates debt)

5. Participation in management: Y Corp. has no rights to participate in management. (Indicates debt)

6. Status equal to or inferior to regular corporate creditors. Shadow warrants have no preference over other corporate debt. (Subordination to debt tends to be indicative of equity)

7. Intent of Parties: Exam concedes that in form the shadow warrants are structured so as to look like debt. The Shadow Warrant Agreement specifically states that nothing in its terms should be construed as conveying the rights of a shareholder. Moreover, it also states that the purpose for granting the Shadow Warrant Agreement is as an inducement to Y Corp. to lend funds to X Corp. (Indicates debt)

8. Thin or adequate capitalization: Here the courts look at both the debt-equity ratio and whether the amount of capital invested in a business venture is realistic and adequate for carrying on the business for which it is organized and engaged. The Motel Co. v. Commissioner, 340 F.2d 445 (2nd Cir. 1965). Where quick assets cannot cover current liabilities, the Fifth Circuit affirmed the Tax Court's determination that a corporation was thinly capitalized and notes were in fact equity. Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712 (5th Cir. 1972). Unable to make a determination from the available facts.

9. Identity of Interest between Creditor and Stockholder: The available facts indicate that Y Corp. has no equity interest in X Corp. There is no indication of the extent to which the two corporations have common shareholders or directors. At this point it appears that Y Corp. and X Corp. are totally unrelated. Even so, the courts have held the fact that a transaction is between unrelated third party will not preclude examination of the substance of a purported loan. Foresun, Inc. v. Commissioner, 348 F.2d 1006 (6th Cir. 1965); The Motel Co. v. Commissioner, T.C. Memo. 1964-34. (Available information Indicates debt)

10. The ability to obtain capital from other sources: The inability to secure financing from another source is considered evidence that the advances are risk capital, rather than debt. *See* Merlo Builders, Inc., *supra*. No facts provided with respect to this issue.

11. The use to which advances were put: To the extent that the funds are used in acquiring the business or to acquire capital assets, it tends to suggest that they are part of the venture capital. *See* Merlo Builders, Inc., supra; Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712 (5th Cir. 1972); No facts were initially provided with respect to this issue. In subsequent telephone conversation, the revenue agent indicated the Date 1

transactions were part of a leveraged buyout. Needs additional factual development.

12. Failure of debtor to repay: While it appears that the contingent payment was in fact made, X Corp. only paid part of what was calculated to be the amount due. There is no explanation for the partial payment.

13. The risk involved: No facts provided with respect to this issue.

In our view, the factor which most strongly weighs in favor of treatment of the shadow warrants as equity is the source of payment. To the extent that the contingent payment is based on the value of the stock and adjustments are required when there is a relative change in the capital structure of X Corp., the contingent payment looks like a dividend. Thus in AMW Investments, Inc. v. Commissioner, T.C. Memo. 1996-235, where no principal or interest was paid until 12 years after the transfer and repayment was contingent on corporate earnings, a thinly capitalized corporation was denied an interest expense deduction on promissory notes. Moreover, the courts have closely scrutinized instruments denominated as debt where a thinly capitalized corporation uses a large portion of cash and/or property required to get the business established and under way. Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712 (5th Cir. 1972); Covey Investment Co. v. United States, 377 F.2d 403 (10th Cir. 1967); Isidor Dobkin v. Commissioner, 15 T.C. 31 (1950) *aff'd. per curiam*, 192 F.2d 392 (2nd Cir. 1951). The scrutiny is not limited to corporation-shareholder transaction but also those transactions involving unrelated third parties. *See, for example* Merlo Builders, Inc. v. Commissioner, T.C. Memo. 1964-34.

[redacted]

In Fin-Hay Realty Co. v. United States, 398 F.2d 694 (3rd Cir. 1968), held that a "loan" from shareholders to a corporation was equity rather than debt even though the notes presented all the formal indicia of debt. The court noted that the loan proceeds had been used to acquire the assets of the corporation and could not have been repaid for a number of years. The court concluded that the economic

reality was that the advances were a long term commitment, dependent on the future value of the asset acquired. Additionally, the court pointed out that the shareholders' willingness to defer repayment of the loan was vastly different from what an outside lender would expect. Similarly here, in the absence of an Exercise Event, Y Corp. was deferring whatever payments it might receive on the warrants for five to ten years. Not only was the Contingent Payment deferred but in the ordinary course of business, repayment of the interest on the revolving loan would not commence until 15 years after the loans were made. Such deferral is not to be expected from most third party lenders.

You have asked about how Monarch Cement Co. v. United States, 634 F.2d 484 (10th Cir. 1980) effects our analysis. In that case, the district court found that stock warrants issued in connection with a loan transaction were an integral part of the loan and the value of the warrants constituted a part of the cost of obtaining the loan. As such, the warrants were an investment unit under Treas. Reg. §§ 1.163-3(a)(2), 1.1232-3(b)(2)(ii)(a), as applicable to obligations issued before May 27, 1969, which entitled taxpayer to amortize and deduct the warrant purchase price. There was no debt-equity analysis in Monarch Cement Co. and the regulations under which that case was decided are inapplicable here.

[redacted]

But as the cases point out, it is the totality of the factors, analyzed in light of the economic reality which dictate the results. [redacted]

[redacted]

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted].

[redacted]

If you have any further questions, please call (202) 622-7920.

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By: _____
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